ON COMPLETION LEASES: A NEW EXCEPTION TO THE RULE AGAINST PERPETUITIES?

Wong v. DiGrazia
60 Cal. 2d 525, 386 P.2d 817, 35 Cal. Rptr. 241 (1963).

Defendants agreed to construct and lease a building to the plaintiffs for a period of ten years, the term to commence on completion of the building. Plaintiffs sought to rescind the lease, contending that it was in violation of the Rule Against Perpetuities.[1] The Supreme Court of California affirmed a judgment for defendants on their cross-claim alleging plaintiff's breach, holding that the Rule Against Perpetuities was not violated. The court reasoned that although the lease designated no certain completion date for the building, the use of such terms as "forthwith" and "continue expeditiously" in the agreement indicated an obligation to complete construction within a reasonable time. Since, under the circumstances, a reasonable time was considered to be less than twenty-one years, the term would vest or fail within the period of the Rule and the interest was therefore held valid.[2]

The Rule Against Perpetuities was developed to curb the inalienability created by the executory interest[3] and to prevent the withdrawal of property from the market place via family settlements.[4] The application of the Rule moved precariously from gift transactions into the commercial area[5] when the Rule was used to invalidate an option to purchase land in the late nineteenth century.[6] Since then the courts have been faced with the task of determining the extent of the application of the Rule in the commercial area.[7]

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[1] The action was originally brought to determine if defendant had breached by refusing to install a sprinkler system. The perpetuities issue was first raised in oral argument before the district court of appeal, which held the lease to be in violation of the Rule Against Perpetuities. Wong v. DiGrazia, 29 Cal. Rptr. 86 (Ct. App. 1963).

[2] Wong v. DiGrazia, 60 Cal. 2d 525, 386 P.2d 817, 35 Cal. Rptr. 241 (1963). California has codified the Rule: "No interest in real or personal property shall be good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest. . . ." Cal. Civ. Code § 715.2.

[3] 3 Simes & Smith, Future Interests § 1232 (2d ed. 1956).

[4] Leach, "Perpetuities in Perspective: Ending the Rule's Reign of Terror," 65 Harv. L. Rev. 721, 736 (1952).

[5] Leach, "Perpetuities: New Absurdity, Judicial and Statutory Correctives," 73 Harv. L. Rev. 1318, 1322 (1960).

[6] 6 American Law of Property § 24.56 (Casner ed. 1952).

[7] 3 Simes & Smith *op. cit. supra* note 3, § 1243; (Rule not applicable to options to renew leases), *id.* § 1244; (applicable to options in gross to purchase land), *id.* § 1246; (not applicable to covenants running with the land), Warner & Swasey Co. v. Rusterholtz, 41 F. Supp. 498 (D. Minn 1941); (not applicable to options to purchase corporate stock), Restatement, Property § 400 (1944). *But see* 3 Simes & Smith, *op. cit. supra* note 3, § 1246.

All of the cases dealing with "on completion" leases have assumed that, because there is a contingent interest, the Rule must be considered. In *Haggerty v. City of Oakland*[8] it was held that there was a possibility that the building might not be completed within the twenty-one year period and the lease was invalidated. The court refused to construct a requirement of reasonableness, stating that the argument was deceptively simple and unsound.[9] In *Isen v. Giant Food, Inc.*,[10] a federal court took a new tack; it held that the language in the instrument gave the lessee a vested interest in a future term and, since the interest was vested, the Rule was inapplicable.[11] The rationale used by some courts to avoid the Rule's operation is that the lessee acquires an *interesse termini*, which is more than a mere right of entry; it is an estate in the land, a vested interest with enjoyment postponed.[12] At common law the concepts of vested or contingent did not apply to the *interesse termini*[13] and Gray, who treats the interest like an estate, asserts that a future term without any subsisting intermediate term would not be a vested interest for purposes of the Rule.[14] Nevertheless, it has been urged that the interest should be accepted as vested because such acceptance provides a device which enables courts to avoid the perpetuities issue.[15] Such illogical reasoning is a costly means of avoiding the issue: if the interest were a fee rather than a leasehold and the appropriate language, "to *B* and his heirs on completion of the building," were used, then an executory interest clearly subject to the Rule would have been created. A classification of interests subject to the Rule should not be based on the quality or quantity of the interest, nor on the manipulation of such a nebulous term as "vest."[16] Regardless of how the language of an "on completion" lease is employed, possession is still subject to a condition precedent

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[8] 161 Cal. App. 2d 407, 326 P.2d 957 (1958).

[9] *Id.* at 420, 326 P.2d at 966. For a criticism of the case see 47 Calif. L. Rev. 197 (1959); 10 Hastings L.J. 439 (1959); Leach, *supra* note 5, at 1318.

[10] 295 F.2d 136 (D.C. Cir. 1961).

[11] "Landlord does hereby lease and demise unto the Tenant [the property] together with the building to be constructed," *id.* at 138. The language in the lease in the present case was, "Lessor [defendants] shall forthwith commence the construction of a building upon the herein *demised* premises. . . ." Wong v. DiGrazia, *supra* note 2, at 528, 386 P.2d at 820, 35 Cal. Rptr. at 244. (Emphasis supplied.) A present demise for a duration of ten years after the completion of the building with the rent postponed until completion should be sufficient language to categorize the interest as "vested." Leach, *supra* note 5, at 1321. Using language of present demise with possession subject to a condition precedent, however, is inconsistent and does confuse the issues.

[12] See Annot., 66 A.L.R.2d 733, 736 (1959); Benjamin v. Northwestern Fire & Marine Ins. Co., 119 Minn. 27, 137 N.W. 183 (1912); DePauw Univ. v. United Elec. Coal Co's., 299 Ill. App. 339, 20 N.E.2d 146 (1939); Reichman v. Drake, 89 Ohio App. 222, 100 N.E.2d 533 (1951).

[13] 3 Simes & Smith, *op. cit. supra* note 3, § 1242.

[14] Gray, The Rule Against Perpetuities § 320.1 (4th ed. 1942).

[15] 37 Notre Dame Law. 561 (1962).

[16] Schuyler, "Should The Rule Against Perpetuities Discard Its Vest?" 56 Mich. L. Rev. 683, 708 (1958).

—completion of the building—and the perpetuities issue should be confronted.

Gray stated that "every provision in a will or settlement is to be construed as if the Rule did not exist, and then to the provision so construed the Rule is to be remorselessly applied."[17] The conception of proper construction under this formula can range from merely interpreting the words used and assessing remote possibilities to actually imposing conditions and validating indefinite transactions. The majority in the instant case prefers the more active role of construction, while the dissent argues for the passive interpretation of possibilities reminiscent of such atrocities as the fertile octogenarian and the unborn widow. The area of wills and trusts is amenable to this passive interpretation, but when the validity of a lease is challenged the rules of construction relating to contracts should be given an opportunity to solve the perpetuities problem.[18] Assume, for example, that plaintiff brings an action for damages for defendant's breach in failing to construct the building twenty years after the creation of the interest. The court must then construe the agreement to ascertain the intent of the parties concerning the time for completion and, if no time was stipulated, it will be assumed that the parties intended completion within a reasonable time. The court must then decide whether this reasonable time is less than twenty years. This construction was made without regard to the Rule and would satisfy Gray's formula should the Rule be later applied to the construction.

In the principal case the plaintiffs conceded that the court could construct a requirement of reasonableness to avoid invalidation for indefiniteness, but argued that once the perpetuities issue was injected the court could not make this construction to avoid violation of the Rule. The dissent, following this reasoning, considers that the majority has disregarded settled rules by making the result depend on reasonable probabilities rather than on the possibility of non-completion which existed at the time the interest was created. If the majority is merely examining the contingent event, deciding that reasonable probabilities show that the event should occur within twenty-one years, and therefore imposing a condition of reasonable time, then, as the dissent implies, the California Code has been effectively amended by the judiciary to require vesting if at all within twenty-one years unless the court decides to impose this condition not contemplated by the parties. The court does have impressive authority, however, for the proposition that a document should be construed if possible to avoid a violation of the Rule[19] and the majority could properly consider this construction of reasonable time to provide another exception to the Rule along with possibilities of reverter, rights of entry, and result-

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[17] Gray, *op. cit. supra* note 14, § 629.

[18] Since leases are generally bilateral contracts as well as conveyances of a property interest, the rules of construction relating to contracts apply. Corbin, Contracts § 686 (1960); Medico-Dental Bldg. Co. of Los Angeles v. Horton & Converse, 21 Cal. 2d 411, 132 P.2d 457 (1942).

[19] Restatement, Property § 375 (1944); 6 American Law of Property § 24.45 (Casner ed. 1952); 3 Simes & Smith, *op. cit. supra* note 3, § 1288.

ing trusts. If the majority is merely looking to the event, they have created an exception to the Rule, but a highly justifiable one when the nature of the interest is considered.

There is, however, an alternative rationale which preserves the traditional application of the Rule. If the court considers its operation to include ascertaining the intent of the parties and finds that the intent was to have completion within a reasonable time, then that time element has always been a part of the lease, just as if the parties had expressly stipulated completion within twenty-one years. Once a requirement of reasonable time is found the court must look to the reasonable probabilities of completion in order to interpret the duration of a reasonable time. Since the parties have excluded unreasonable probabilities by their lease, the Rule can be "remorselessly applied" without voiding the interest. This analysis eliminates any exception to the Rule and the subtle difference depends on whether the court looks to the intention of the parties or uses the objective method and examines the event.[20]

The next question is: to what kind of transactions can the construction of reasonableness be applied? When trustees have been given discretion as to the time of distribution of the res, the courts have construed a requirement of reasonable time.[21] The construction has been used where the settlor gave a general direction to the trustee to sell property after an indefinite period of time.[22] A construction of reasonableness has been used where a leasehold for the removal of timber was to commence at any time the lessee might desire.[23] The cases have this much in common: the court is in a position to control the contingent event because it is controllable by one of the parties. The trustee is subject to a surcharge if he fails to perform the duty within a reasonable time and the lessor or lessee is subject to damages for breach if he fails to perform within a reasonable time. The court can control the result by manipulating remedies. Since the event must be subject to control by one of the parties, this would eliminate a lease from *A* to *B*, the term to commence when *X* constructs a building on some other premises, *X* being a stranger to the parties. This is analogous to an aleatory contract and the fortuitous event, because not subject to the control of one of the parties, is therefore not controllable by the court. The construction of reasonableness does not belong in this example even if the parties intended *X* to construct within a reasonable time.[24]

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20 This distinction between objective and subjective analysis may be considered highly nebulous since in practice decision is probably dependent on both, and there is little judicial review. For some of the problems in interpretation when no time limit for performance is stated, see Corbin, Contracts § 553 (1960).

21 Myers v. Hardin, 208 Ark. 505, 186 S.W.2d 925 (1945); Brandenburg v. Thorndike, 139 Mass. 102, 28 N.E. 575 (1885).

22 Smith v. Renne, 382 Ill. 26, 46 N.E.2d 587 (1943); Harrison v. Kamp, 395 Ill. 11, 69 N.E.2d 261 (1946).

23 Kirkland v. Odum, 156 Ga. 131, 118 S.E. 706 (1923); Gex v. Dill, 86 Miss. 10, 38 So. 193 (1905).

24 This analysis should apply to options to purchase when a specific time has not been expressed, since the occurance of the contingent event is within the discretion

The plaintiff also argued that even with the construction of reasonableness, the interest might vest beyond the period of the Rule because the defendant might fail to construct the building in time and the plaintiff might waive the breach. The court wisely rejected the argument, pointing out that this would be possible even if there were an express provision limiting completion to twenty-one years. Every event which is dependent on the duty of a party is subject to some form of waiver and to assume that parties are willing to enforce their rights is only proper. The interests which would be void under a contrary assumption would be preposterously numerous.

The policy underlying the Rule has not been universally agreed upon, but there is some accord that its purpose is to promote alienability and hence to make property more productive.[25] The conflict appears to center on the application of the Rule and whether it is aimed at remoteness of vesting or inalienability.[26] If alienation to third parties were the primary policy, then there might be a practical barrier in persuading the lessor and lessee to join in a conveyance in fee and also in evaluating the lessee's interest.[27] If the basic policy, however, is not to promote marketability per se but to facilitate productive use of the land, then the Rule should not be applied in this area. The reasons for this can be found in an analogous situation, the option to renew a lease or an option to purchase contained in a lease. A provision of this sort is valid even though it creates an equitable contingent interest which may last beyond the period of the Rule.[28] This apparent exception to the Rule can only be explained on a policy basis. Without the option, the lessee would be inhibited in making improvements to the land because the benefits of such improvements would accrue to the lessor and not the lessee.[29] The option makes the lease more attractive to the purchaser and therefore promotes alienation rather than impeding it,[30] and encourages full use of the land once the lessee takes possession. In the option situation the beneficial results accrue to the lessee,

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of the optionee and could be controlled by the court. A further reason for application here is that we are squarely within the realm of contracts where a reasonable time construction is commonplace. The problems are more manifest with leases because of the mixed elements of contract and property law. Before the construction of reasonableness is used, it should be necessary to find mutual covenants in order to set the proper stage for contract rules, but in this case the promise to pay rent and the promise to construct are clearly mutual.

[25] Simes, "The Policy Against Perpetuities," 103 U. Pa. L. Rev. 707, 710 (1955).

[26] Simes resolves this conflict, *id.* at 711-712, and then later in the article contends that the productive policy is outmoded by present conditions and believes it is actually a policy against dead hand control. Gray, who espoused the remoteness argument in application, agrees that the actual policy is to promote marketability by characterizing the Rule as "forwarding the circulation of property," Gray, *op. cit. supra* note 14, § 2.1.

[27] 47 Calif. L. Rev. 197 n. 6 (1959).

[28] Restatement, Property § 395 (1944); 6 American Law of Property § 24.57 (Casner ed. 1952).

[29] Leach, "Perpetuities in a Nutshell," 51 Harv. L. Rev. 638, 661 (1938).

[30] Simes & Smith, *op. cit. supra* note 3, § 1243.

but in the present transaction the lessor acquires the advantage. Without the lease, the lessor would be more than hesitant to commence any construction, but once a market is insured through the "on completion" lease, construction will be forthcoming. The property has been improved and is now more productive.[31] Instead of a removal of property from the commercial stream there has been an addition unless removal is equated with the failure to convey a fee simple. Such a restricted definition would relegate the Rule to nothing more than a farce, with the policy consideration being to sell, merely to be selling. If the chief policy is the productivity or improvement theory, the present transaction is extremely foreign to the Rule and should be categorized as another exception along with options to renew and purchase contained in leases. Although the court reached the proper result, by placing the present transaction in the mainstream of the Rule, it permits further contentions; the more dispositive approach would have been not to apply the Rule.[32]

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[31] Leach, *supra* note 5, at 1319.

[32] This case is also noted in 9 Vill. L. Rev. 545 (1964), where it is advocated that the Rule should not apply to commercial transactions since the rules pertaining to restraints on alienation are capable of preventing any fettering of interests.